10. The problem is that the common line basket recovers costs associated with a single network element (the loop) but historically has contained rates for two different services. End users have paid subscriber line charges ("SLCs") on a monthly basis for each of their lines, while interexchange carriers have paid the carrier common line ("CCL") charge for every minute of interstate switched access. A second problem is that the SLCs are separately capped under the price cap plan and cannot move as the PCI for the common line basket moves. Thus, changes in the common line PCI do not impact common line services equally; rather, they impact only the CCL and the price interexchange carriers pay for switched access service. Given the constraint on the SLCs, the object of any allocation of sharing adjustments to the baskets should be to approximate as closely as possible, the prices (or price limits) for services that would pertain if there were no restrictions on the SLCs. Since, by assumption, the sharing adjustment reflects a reduction in costs of all services by the same proportion, we would like to see equal proportional reductions in prices (or price limits) for all services. Such an allocation would minimize the distortion caused by the constraint that SLCs neither rise nor fall in response to changes in costs.[7] In contrast, the effect of allocating a sharing adjustment on the basis of total common line revenue would be to weight <u>dis</u>proportionately the remaining services in the common line basket, namely the CCL charge.

11. Consider a 10 percent exogenous cost change—like a sharing adjustment—that reflects a proportional reduction in all costs and should therefore reduce all price limits proportionally. Suppose, for simplicity, the revenue share of each basket was 25% and half the common line basket corresponded to SLC revenue and half to CCL revenue. If the reduction were allocated across the price cap baskets using all revenues (including SLC revenue), PCIs would fall by 10 percent in each basket. However, <u>prices</u> would not change in those proportions because in the common line basket, the CCL would fall by 20 percent and SLCs would remain

[7] This is the economic reason that deviating from an allocation based on total common line basket revenue is the correct approach. It is *not* an attempt to allocate the sharing adjustment disproportionately to baskets following some notion of disproportionate responsibility for productivity growth (which was rejected in the *1992 Annual Access Tariff Order*). Rather, it is a necessary adjustment in the allocator to achieve what was ordered in the *1992 Annual Access Tariff Order*: an equiproportional flow-through of the earnings adjustment to all interstate services.

constant. This reduction would distort the relationship among prices and costs across the price cap baskets: for example, switched access prices would fall by more than 10 percent while special access prices would fall by exactly 10 percent. Under these assumptions, assigning the exogenous cost change to baskets by revenue is not cost-causative and potentially distorts interexchange carriers' choices of access services. In contrast, if SLC revenues are ignored in the allocation, the CCL and the PCIs for the remaining (non common line) baskets fall by the same amount (11.4 percent of revenues less SLC) so that the requirement that SLCs remain unchanged does not distort the proportional price reductions among services in different baskets, such as switched and special access.

12. As the above discussion demonstrates, the method employed by Bell Atlantic to allocate sharing was reasonable from an economic standpoint, was consistent with the previous Commission determination that an earnings sharing adjustment should be spread proportionally across all services, and was also consistent with the objectives of the Commission's price cap rules. Given that Bell Atlantic's method of assigning the sharing adjustment on a cost-causative basis has been determined to be incorrect, the question has become one of how its PCIs, SBIs and CCL should change to correct the errors in the 1993-1996 filings and how refunds of overcharges—if any—should be calculated and implemented.

III. ONE-TIME CHANGES TO REFUND OVERCHARGES ARE UNWARRANTED.

13. Subsection C of the *1993-96 Access Tariff Order* sets out only part of the required calculations to correctly determine the amount of any "refund to ... customers all amounts, plus interest, collected as a result of overcharges."[8] Basically, the portion of the calculation included in the order would classify a customer as "overcharged" if, at half-year periods from 1993 through 1996, any API exceeds its corresponding PCI, any SBI exceeds its upper limit or any CCL rate in effect exceeds the maximum CCL rate. The order does not, however expressly set out the rest of

[8] *1993-96 Access Tariff Order* at ¶ 104.

the calculation required to correctly determine the amount of any overcharge to be refunded through a 1997 one-year exogenous cost change.

14. To fully adjust for the change in allocation method, the Commission must include an equivalent adjustment to reflect the amount of sharing over-allocated to the remaining three baskets. Each basket, calculated independently, should have a one-time adjustment to its PCI, to reflect such a change.[9] While the customers for services in those baskets also pay CCL charges, they benefited from the additional sharing that was allocated to them by virtue of the exclusion of end-user revenues in Bell Atlantic's original allocation to the CCL Basket. If the Commission has determined that Bell Atlantic should be required to correct for the impacts of such exclusion, all such impacts must be addressed. To do otherwise, as explained below, would be to distort the final sharing amounts so that they would not be consistent with the Commission's revised allocation method, or with the price cap rules in general.

A. Performing only a partial calculation would distort the incentives in the price cap plan.

15. In contrast to the correct method for reconstructing Bell Atlantic's indices, performing only the portion of the calculations set out in the order would effectively require Bell Atlantic to share a larger portion of its earnings in each of the years 1993 through 1996 than the amount called for in the price cap plan. It is generally recognized that the sharing of earnings has deleterious effects on the incentives for regulated firms to reduce costs and expand output.[10] To the extent that the refund calculation were performed in a way that increases the sharing obligation of the regulated firm, it reduces the firm's incentives to undertake activities that increase earnings. In addition, the fact that the refund calculation treats interstate services asymmetrically—reducing switched access price limits more than proportionately and special access and interexchange price limits less than proportionately—further distorts incentives from

[9] The result may be to create additional distance between the PCI and the API for those baskets. Consistent with the price cap rules, a carrier is free to adjust its prices up or down, so long as they do not exceed the PCI.

[10] Indeed, earnings sharing has been eliminated in the price cap plan changes announced by the FCC on May 7.

those that an unregulated firm would face in competitive markets where proportionate reductions in costs across services would—all else equal—result in proportionate reductions in service prices. Similarly, the asymmetric treatment of errors that resulted in a cap higher than otherwise allowed, and those that lead to a cap lower than otherwise allowed would change the risk that the regulated firm faces when it is required to calculate parameters of the price cap plan for long periods of time with no explicit directions beyond general principles.

16. In addition, the fact that the price cap plan parameters are subject to regulatory change—as long as four years after the fact—increases the regulatory risk in a price cap plan that was intended to reduce regulatory uncertainty. In unregulated, competitive markets, firms believe that actions they take to increase productivity growth will result in higher profits, and accordingly they risk their capital and effort in the expectation that they will be rewarded if they are successful in the market. In theory, price-cap regulated firms face similar incentives because increased productivity growth leads to higher earnings, provided only that the higher earnings are not achieved by increasing prices above the amount allowed by the various price cap indices. If the rules of the price cap plan change in mid-stream, firms will no longer treat the parameters of the plan as fixed and attempt to maximize profits. As observed in the economic literature on incentive regulation

> (i)f large financial rewards and penalties are linked to performance measures over which the [regulated] firm has relatively little control. the firm will be exposed to substantial risk. and corresponding gains from improved incentives will be minimal.[11]

Ultimately, it is the belief of the regulated firm that the deck is not stacked and that increased productivity will lead to increased profits that generates the improved performance associated with price cap regulation. Regulatory decisions that undermine those beliefs threaten the benefits that customers expected to receive from adoption of price cap regulation.

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[11] D. Sappington and D. Weisman. *Designing Incentive Regulation for the Telecommunications Industry*. Cambridge: MIT Press. 1996. p. 334.

B. Performing only a partial calculation would not compensate customers for overcharges.

17. According to the *1993-96 Access Tariff Order*, the refund liability "must compensate customers for overcharges incurred during the course of this investigation." (at ¶104). Thus, if no customer paid more than if Bell Atlantic had allocated its sharing obligation in accordance with the *1993-96 Access Tariff Order*, then no customer suffered damages and there is no refund liability. This standard is consistent with the incentive structure of the FCC's price cap plan, where the firm is left free to set prices wherever it can, provided that various price ceilings (the PCI, SBIs, and the maximum CCL) are respected. Only when the actual API exceeds the PCI recalculated in accordance with the *1993-96 Access Tariff Order*—or when an actual SBI or CCL rate exceeds the recalculated maximum SBI or CCL rate—would a customer have paid more than it would have if Bell Atlantic allocated its earnings sharing adjustment according to the new Order. Hence, the refund obligation should compare what customers were charged relative to the maximum that they would have been charged had Bell Atlantic calculated its sharing adjustment as required in the *1993-96 Access Tariff Order*.

18. The result of that calculation can be positive or negative in any basket, and, in aggregate, customers of interstate services were not overcharged at all. The correct amount of earnings sharing adjustment was calculated and returned to customers through reductions in the PCIs, SBIs and CCL rates over all four baskets in every year. If the allocation had been done in accordance with the *1993-96 Access Tariff Order*, the allocation across baskets would have been different in each year, but the total amount returned to customers would have remained the same as was actually returned to customers in each year.

C. The proposed method of calculation is incomplete and incorrect.

19. Performing only the partial calculation set out in the *1993-96 Access Tariff Order* would not calculate the amount by which customers were overcharged, including interest. First, even focusing only on the Common Line Basket, there appears to be double-counting in the overcharge calculation which simply sums the overcharges associated with the PCIs, SBIs and the maximum CCL rate as if these price limits were independent. Suppose one rate element—for

example, the CCL—were incorrectly priced too high so that, in addition, both the API and an SBI exceeded its corresponding PCI and SBI upper bound. The amount by which a customer was overcharged is the excess revenue from the overpriced CCL rate element, not the sum of the revenues associated with the excess API, SBI and maximum CCL rate.

20. Second, performing only the partial calculation—that is if the offsetting undercharges were ignored—would force Bell Atlantic to share more than the amount required in the price cap plan. This not only would be inconsistent with the Commission's own rules, but it would be unwise economic policy since it would undermine the very incentives price caps were designed to create.

21. Third, if total common line revenue were used to allocate the earnings sharing adjustment, switched access price limits would fall by a greater percentage than special access or interexchange price limits, despite the assumption in the *1992 Access Tariff Order* that earnings derive from <u>all</u> interstate services and thus that all interstate service costs have fallen proportionately, and price limits should follow proportionately.

IV. PERMANENT CHANGES TO CORRECT PRICE LIMITS ARE UNNECESSARY.

22. Unlike some of the other investigation issues resolved in the *1993-96 Access Tariff Order*, a misallocation of the earnings sharing adjustment has no permanent effect on price limits. Since each exogenous adjustment to implement sharing is effectively removed at the next annual filing, any error in Bell Atlantic's PCIs (and other pricing limits) lasts only one year.[12] Thus if it were determined that Bell Atlantic's allocation of sharing adjustments were incorrect in every year, no change would be required to the calculations of Bell Atlantic's PCIs, SBIs and maximum CCLs to become effective June 30, 1997. The (incorrect) adjustments made in June 1996 must be reversed—as they would be absent the *1993-96 Access Tariff Order*—and the new exogenous adjustment for sharing (if any) must be allocated across the price cap baskets in accordance with

[12] Thus any error in the 1993 filing affects the July 1993 and January 1994 PCIs but not the July 1994 (and future) PCIs. Similarly, errors in the 1994 filing have no effect on the PCIs on or after July 1995, etc.

the current *1993-96 Access Tariff Order*, but for these particular errors it is not the case that "an uncorrected error in one year's PCI causes an error in next year's PCI."[13] Thus the calculations in Subsection B of the *1993-96 Access Tariff Order* are unnecessary to reset the 1997 PCIs, SBIs and maximum CCL to make them consistent with "what would have been in place had they been calculated consistent with the Commissions rules and decisions."

V. CONCLUSIONS

23. Requiring Bell Atlantic to overcompensate interstate customers for overcharges in one basket without offsetting against that compensation undercharges in other baskets would expose Bell Atlantic to a level of sharing beyond that set out in the price cap plan. Changing price cap rules in mid-stream would expose all price-cap regulated firms to additional regulatory risk which would reduce the improvement in incentives that price cap regulation was intended to produce. The Commission should confine the refund from Bell Atlantic's allocation of the earnings sharing adjustment to the overcharges that interstate customers actually paid (including interest), netting out the overcharges in the common line basket against the undercharges in the traffic sensitive, special access and interexchange baskets.

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[13] *1993-96 Access Tariff Order* at ¶ 97, footnote 220.

William E. Taylor

William E. Taylor

Subscribed and sworn to before me this

16th day of May, 1997.

Eleanor Fort Shike

Notary Public

My commission expires

ELEANOR FORT SHIKE
Notary Public, State of New York
No 31-8974420
Qualified in New York County
Commission Expires March 30, 1998

EXHIBIT 2

BELL ATLANTIC TRANSMITTAL NO. 777
RECALCULATION OF SHARING DISTRIBUTION

	SOURCE	COMMON LINE (A)	TRAFFIC SENSITIVE (B)	TRUNKING (C)	INTER-EXCHANGE (D)	TOTAL (E) = (A + B + C + D)
1. 1995 Annual Filing R	Tran. 777, TRP, PCI - 1	1,345,342,722	516,338,550	921,355,536	137,567,909	2,920,604,717
2. Distribution of Revenues	Line 1 Current Col./Line 1 Col. E	46.0607%	17.6848%	31.5446%	4.7099%	100.0000%
3. 1993 Sharing True-up	Line 2 Current Col.*WP 8-57 Line 2	(1,889,409)	(725,431)	(1,293,959)	(193,201)	(4,102,000)
4. 1994 Add Back	Line 2 Current Col.*WP 8-57 Line 3	(8,031,602)	(3,083,699)	(5,500,420)	(821,271)	(17,437,000)
5. 1994 Sharing	Line 2 Current Col.*WP 8-57 Line 1	(32,678,215)	(12,546,660)	(22,379,617)	(3,341,508)	(70,946,000)
6. 1994 Total Sharing - Calculated	Sum Line 3..Line 5	(42,599,226)	(16,355,790)	(29,174,003)	(4,355,980)	(92,485,000)
7. 1994 Total Sharing - Filed	Tran. 777, WP 8-57-4, Line 6	(20,920,112)	(23,463,608)	(41,852,298)	(6,248,982)	(92,485,000)
8. Difference	Line 6 - Line 7	(21,679,114)	7,107,818	12,678,295	1,893,002	0

1995 Annual Access Tariff
Petition of AT&T Corp.
(filed May 30, 1995)

LL ATLANTIC RECALCULATION OF SHARING DISTRIBUTION

	SOURCE	COMMON LINE	TRAFFIC SENSITIVE	TRUNKING	INTER-EXCHANGE	TOTAL
		(A)	(B)	(C)	(D)	(E)
1996 Annual Filing R Distribution of Revenues	Tran. 867, TRP, PCI-1 Line 1/Line 1 Col. E.	1,284,822,564 45.816%	482,983,648 17.223%	924,395,618 32.963%	112,123,129 3.998%	2,804,324,959
1995 Sharing - Dist. Calc.	Line 2*Total Sharing Col E	(13,541,762)	(5,090,547)	(9,742,937)	(1,181,754)	(29,557,000)
1995 Sharing - Filed	T867, WP 8-53-4, Line 5+6	(5,540,143)	(7,628,889)	(14,601,140)	(1,786,817)	(29,556,989)
Difference	Line 6 - Line 7	(8,001,619)	2,538,342	4,858,203	605,063	(11)

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CIFIC BELL RECALCULATION OF SHARING DISTRIBUTION

	SOURCE	COMMON LINE	TRAFFIC SENSITIVE	TRUNKING	INTER-EXCHANGE	TOTAL
		(A)	(B)	(C)	(D)	(E)
1996 Annual Filing R Distribution of Revenues	Tran. 1864, TRP, PCI-1 Line 1/Line 1 Col. E.	888,523,273 53.796%	304,871,174 18.459%	458,103,176 27.736%	142,620 0.009%	1,651,640,243
1995 Sharing - Dist. Calc.	Line 2*Total Sharing Col E	(17,855,594)	(6,126,633)	(9,205,954)	(2,866)	(33,191,046)
1995 Sharing - Filed	T1864, WPIIC-11	(7,278,386)	(10,781,259)	(15,067,042)	(64,359)	(33,191,046)
Difference	Line 6 - Line 7	(10,577,208)	4,654,626	5,861,088	61,493	-

1996 Annual Access Tariff
Petition of AT+T Corp.
(filed Apr. 29, 1996).

L ATLANTIC TRANSMITTAL 644

ALCULATION OF SHARING DISTRIBUTION

	SOURCE	COMMON LINE (A)	TRAFFIC SENSITIVE (B)	TRUNKING (C)	INTER EXCHANGE (D)	TOTAL E=(A+B+C+D)
1993 INTERSTATE REVENUES	Note 1	1,336,208,040	485,937,801	853,077,223	142,438,351	2,817,661,415
DISTRIBUTION FACTOR	Ln1 Col/Ln1 ColE	0.474226	0.172461	0.302761	0.050552	
1993 SHARING DISTRIBUTION	Ln1*Ln2	(28,404,235)	(10,329,747)	(18,134,157)	(3,027,861)	(59,896,000)
REVENUES USED BY BELL ATLANTIC	WP 8-53-4	478,858,233	485,937,042	853,077,223	142,238,351	1,960,110,849
BELL ATLANTIC DISTRIBUTION FACTOR	WP 8-53-4	0.2443	0.2479	0.4352	0.0726	
BELL ATLANTIC SHARING DISTRIBUTION	WP 8-53-4	(14,632,689)	(14,848,999)	(26,067,869)	(4,346,442)	(59,895,999)
DIFFERENCE	Ln3-Ln6	(13,771,546)	4,519,252	7,933,712	1,318,581	(1)

e 1: Line 1, Col A = 1993 base period R(t-1) Revenues from Bell Atlantic Transmittal 644, TRP PCI 1 Chart.
e 2: Line 3, Col E = 1994 Total Sharing as reported by Bell Atlantic Transmittal 644, Workpaper 8 53 1.

1994 Annual Access Tariff
Petition of AT+T Corp.
(filed Apr. 26, 1994)

sharing amount properly among that carrier's service baskets, by omitting end user line charges from the Common Line basket's revenues, despite the Commission's finding in the 1992 Tariff Order that sharing should be allocated in proportion to basket revenues.[57] The effect of this misallocation was to understate the sharing amount (and, hence, overstate Bell Atlantic's rates) in the Common Line basket by almost $1.9 million.[58]

The June 23 Order (¶ 42) agreed with AT&T that this procedure raised questions concerning the validity of Bell Atlantic's price cap adjustments, and required Bell Atlantic to justify its sharing allocation methodology.

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[57] 1992 Tariff Order, 7 FCC Rcd. at 4732-33.

[58] This allocation methodology also correspondingly overstated the sharing amounts, and understated the access rates, for Bell Atlantic's other baskets. The sharing amounts as filed by Bell Atlantic, and as corrected to reflect the inclusion of end user revenues in the allocation process, are as follows:

	As filed		Corrected	
Basket	Amount (\$ mil)	Percent	Amount (\$ mil)	Percent
Common Line	$1.749	21.0	$3.606	43.4
Traffic Sensitive	$4.299	51.7	$3.083	37.1
Special Access	$1.861	22.0	$1.118	14.3
Interexchange	$ .600	7.2	$ .432	5.2

1993 Annual Access Tar
AT+T Opposition to Dire
Cases
(Filed Aug. 24, 1993)

EXHIBIT 3

BELL ATLANTIC

Exhibit 3

IMPACT OF PARTIAL CORRECTION BY REDISTRIBUTING SHARING TO COMMON LINE BASKET ONLY
(Dollars)

LN	ITEM	SOURCE	(A) Amount Shared in 1993 Access Tariff	(B) Amount Shared in 1994 Access Tariff	(C) Amount Shared in 1995 Access Tariff	(D) Amount Shared in 1996 Access Tariff
1	Total 50% Tariff Sharing	Total Amount Shared (based on 50% of prior years' earnings above 12 25%) Note 1	(2.025.000)	(60.668.000)	(92.485.000)	(74.910)
2	Impact of Sharing Redistribution on Common Line	Amended 1997 TRP. Ln 9. WP S-1. S-2. S-3 and S-4	0	(13.951.097)	(21 679.114)	(20.267)
3	Adjusted Sharing with Redistribution to CL Basket Only	Ln 1 + Ln 2	(2.025.000)	(74.619 097)	(114 164 114)	(95.177)
4	Percent Increase in Sharing with Redistr to CL Basket Only	(Ln 3 - Ln 1) / Ln 1	0 00%	23 00%	23 44%	27 06%
5	Effective Sharing on Earnings above 12 25%	Ln 3 / (Ln 1 * 2). Note 2	50 00%	61 50%	61 72%	63 53%

Note 1
- Column A from BA Transmittal No 568-A. WP 8-52-D
- Column B from BA Transmittal No 644. WP 8-53-4
- Column C from BA Transmittal No 777. WP 8-57-4
- Column D from BA Transmittal No 867. WP 8-53-4

Note 2
Line 5 amounts reflect the proportion of earnings above 12 25% that would effectively be shared if sharing redistribution is applied to Common Line Basket only

Bell Atlantic Reply Comments

ATTACHMENT 2

Bell Atlantic
Comparison of Sharing Flow-Through Methods

Line	Item	Source	Amount
1	Existing PCI (May 8th filing)	Exhibit 2, Pg 2 Col A, ln 23	74.8372
2	Re-calculation of Existing PCI after flow through of Sharing	Exhibit 2, Pg 2 Col B, ln 23	75.0032
3	Proposed PCI (May 8th filing)	Exhibit 2, Pg 2 Col A, ln 24	68.2675
4	Re-calculation of Proposed PCI after flow-though of Sharing	Exhibit 2, Pg 2 Col B, ln 24	68.5536
5	Exogenous Cost Amount via BA direct method	Letter filing 5/8 WP S	(40,914,722)
6	Exogenous Cost Amount via Sharing flow through method	Exhibit 2, Pg 3	(38,462,681)
7	Exogenous Cost Difference	Line 6 - Line 5	2,452,041

Comparison of Common Line PCI Development Using a Direct Recalculation of the Sharing Reallocation Versus a Flow-Through Method for Restating Indices

	Direct Calculation (As Filed on 5/8/97)	Flow-Through Restatement of the Indices
100 GDP-PI	2.1120	2.1120
110 Productivity Factor (X)	5.3000	5.3000
120 GDP-PI - X	-3.1880	-3.1880
130 Y(t-1)	N/A	N/A
140 Delta Y	N/A	N/A
150 Delta Z	(43,174,825)	(40,700,439)
160 R(t-1)	1,300,362,652	1,300,362,652
170 Delta Y/R	N/A	N/A
180 Delta Z/R	-3.3202	-3.1299
190 W	96.6798	96.8701
200 W*(GDP-PI - X)	N/A	N/A
210 Growth in Min./Line (g)	5.2100	5.2100
220 W*[GDP-PI - X - (g/2)] / [1 + (g/2)]	-5.4585	-5.4692
230 Recalculated Existing PCI	74.8372	75.0032
240 Recalculated Proposed PCI	68.2675	68.5536

BELL ATLANTIC

1993 - 1996 Recalculation of Common Line Sharing
Using the Flow-Through Method
(With Interest)

Item	Common Line
1 Total 1993 Revised Sharing	0
2 Total 1994 Revised Sharing	(14,565,719)
3 Total 1995 Revised Sharing	(23,896,962)
4 Total 1996 Revised Sharing	0
5 Total Change	(38,462,681)

CERTIFICATE OF SERVICE

I hereby certify that on this 27th day of May, 1997, a copy of the foregoing "Bell Atlantic Reply Comments" was sent by first class U.S. mail to the parties on the attached list.

Jonathan R. Shipler

Jonathan R. Shipler

* BY HAND

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